

South Carolina Law Review

Volume 42
Issue 1 *ANNUAL SURVEY OF SOUTH CAROLINA
LAW*

Article 3

Fall 1990

Business Law

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Recommended Citation

Matthew J. Norton, et. al., Business Law, 42 S. C. L. Rev. 1 (1990).

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SOUTH CAROLINA LAW REVIEW

VOLUME 42

AUTUMN 1990

NUMBER 1

BUSINESS LAW

I. · EVEN THOUGH PARTNERS DID NOT CREATE AN EXPRESS AGREEMENT, A PARTNERSHIP WILL NOT BE AT WILL IF EVIDENCE EXISTS THAT THE PARTNERS ENVISIONED A DEFINITE TERM OR UNDERTAKING

In *Beck v. Clarkson*¹ the South Carolina Court of Appeals held that (1) even though the partners did not create an express agreement, the partnership may not be at will if the partners envisioned the accomplishment of a definite term or undertaking, and (2) a partner continues to owe a fiduciary duty to other partners even after the dissolution of the partnership. In *Beck* the court of appeals sent to a jury the question whether a partner should be awarded a share of the partnership's anticipated profits even though the partners did not create a partnership agreement and the partner's role in the business ended before the partnership acquired assets or transacted business.²

In January 1985 Beck agreed to form a partnership with the defendant Clarkson and a third party. The group formed the partnership to build and develop a warehouse facility and to lease the warehouse to Spring City Knitting Company (Spring City), a division of Cluett, Peabody Company (Cluett). Beck's wife assisted Clarkson in researching a proposal that they submitted to Cluett, but in July 1985 Clarkson told Beck that he would not be included in Clarkson's further negotiations with Cluett. Between July and September 1985 Clarkson formed another partnership with her family, and in September the new part-

1. 300 S.C. 293, 387 S.E.2d 681 (Ct. App. 1989).

2. *Id.* at 295-96, 387 S.E.2d at 682-83.

nership contracted to purchase the land for the Spring City warehouse facility. Clarkson built the warehouse facility, and in January 1986 she leased the facility to Spring City. Beck sued Clarkson for future damages.³

The trial court granted a directed verdict for the defendant on the grounds that Beck failed to prove (1) that a partnership existed, (2) that Clarkson was liable for damages because any partnership formed was a partnership at will, and the partners dissolved the partnership before they owned property or transacted business, and (3) that the damages Beck sought were not reasonably certain. The court of appeals, however, reversed the trial court and remanded the case for a new trial.⁴

First, the court of appeals entertained the question whether a partnership existed between the parties. Both parties agreed that they did not form an express verbal or written agreement.⁵ Thus, the test used by the court to determine the existence of a partnership is found in the Uniform Partnership Act (U.P.A.), which the South Carolina Legislature adopted in 1950.⁶ South Carolina Code section 33-41-210 states, "A partnership is an association of two or more persons to carry on as co-owners a business for profit."⁷ The court also added that "[a] partnership agreement may rest in parol. The agreement may even be implied and without express intention."⁸

In *Beck* the court of appeals instructed the reader to study carefully the language of *Stephens v. Stephens*⁹ when considering the existence of a partnership.¹⁰ In *Stephens* the South Carolina Supreme Court held that "[o]ne of the most important tests as to the existence of a partnership is the intention of the parties."¹¹ The court also found, however, that "when all of the conditions exist which by law create a legal relationship, the effects flowing legally from such relation follow whether the parties foresaw and intended them or not."¹² The supreme court decided *Stephens* before South Carolina adopted the Uniform Partnership Act, but the South Carolina Code has incorporated the

3. *Id.* at 295-97, 387 S.E.2d at 682-83.

4. *Id.* at 297, 387 S.E.2d at 683.

5. *Id.* at 300, 387 S.E.2d at 685.

6. *See* S.C. CODE ANN. §§ 33-41-10 to -1090 (Law. Co-op. 1990).

7. *Id.* § 33-41-210.

8. *Beck*, 300 S.C. at 301, 387 S.E.2d at 685 (quoting *Wyman v. Davis*, 223 S.C. 172, 74 S.E.2d 694 (1953)); *see also* *Buffkin v. Strickland*, 280 S.C. 343, 312 S.E.2d 579 (Ct. App. 1984).

9. 213 S.C. 525, 50 S.E.2d 577 (1948).

10. 300 S.C. at 301, 387 S.E.2d at 685.

11. 213 S.C. at 530, 50 S.E.2d at 579.

12. *Id.* at 531, 50 S.E.2d at 579.

idea that parties can create a partnership without express intention.¹³ The *Stephens* court held that when partners do not form a partnership by agreement, a partnership is formed if the parties have an equal right to control the management of the business and if the parties are sharing profits and losses.¹⁴ In *Beck* the court held that the parties displayed the necessary intent to send the question to a jury whether the parties formed a partnership. The court found the following evidence persuasive: (1) Beck testified that the parties agreed to share profits and losses; (2) Beck's wife had procured plats and contacted the owners of all the property that surrounded Spring City's plant; and (3) the letterhead on certain documents listed Beck as a partner.¹⁵

Once the court of appeals decided that a partnership might exist, it focused on whether the breaching party could be liable for damages, and in doing so, entertained whether the parties had dissolved the partnership. In *McPherson v. J.E. Sirrine & Co.*¹⁶ the South Carolina Supreme Court held that when a partnership agreement does not fix any definite time for the termination of the partnership, the partnership is a partnership at will, subject to dissolution by any partner at any time.¹⁷ Clarkson argued that because the parties did not fix any definite time for terminating the partnership, the partnership was at will and, thus, Clarkson dissolved the old partnership when she formed the new partnership. She thought that she no longer owed any duty to Beck.¹⁸ In *Beck*, however, the court of appeals stated that the *McPherson* rule should be construed broadly. The court ruled that even though Beck and Clarkson did not expressly agree to the termination date of the partnership, the parties envisioned the accomplishment of a definite undertaking, namely the building and leasing of a warehouse to Spring City contingent only upon the decision of Spring City to do business with the partnership.¹⁹ The court remanded the case for a

13. See S.C. CODE ANN. § 33-41-210 (Law. Co-op. 1990).

14. 213 S.C. at 532, 50 S.E.2d at 580.

15. *Beck*, 300 S.C. at 300-01, 387 S.E.2d at 685.

16. 206 S.C. 183, 33 S.E.2d 501 (1945).

17. *Id.* at 207, 33 S.E.2d at 511.

18. *Beck*, 300 S.C. at 303, 387 S.E.2d at 686; see also *Weeks v. McMillan*, 291 S.C. 287, 353 S.E.2d 289 (Ct. App. 1987) (withdrawal of two partners and the admission of two new partners created an ipso facto dissolution of the original partnership).

19. *Beck*, 300 S.C. at 302, 387 S.E.2d at 686. The court adopted the rule set forth in AM. JUR. 2d:

If a partnership is one at will, *without any definite term or definite undertaking to be accomplished*, a dissolution by the election of one party is not a breach of contract, so that the terminating party incurs no liability, whatever the motive for the termination may have been, and whatever may be the injurious consequences to his copartners who have neglected to protect themselves by an agreement to continue for a definite term.

jury trial to determine whether the parties envisioned a definite undertaking. If they did, the court would find that the parties had agreed to a definite term, the agreement would not be at will, and the breaching party would not be immune from liability.²⁰

The court of appeals is breaking new ground with this point. Most parties that enter into a partnership arrangement have envisioned some definite undertaking to be accomplished. By adopting the language from *American Jurisprudence*, the court of appeals has made it very difficult for partners to exist in an at-will relationship. The U.P.A. governs partnership relationships in the absence of any agreement. South Carolina Code section 33-41-910²¹ states that "dissolution of a partnership is the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on . . . of the business" and section 33-41-930(1)(b)²² states that dissolution is caused "by the express will of any partner when no definite term or particular undertaking is specified." The U.P.A. only carves out the "definite undertaking" exception when the undertaking is specified in an agreement.²³ The court of appeals construes the language of the U.P.A. very broadly when it holds that if the parties envision a definite undertaking, the partnership will not be at will regardless of whether the parties entered into an agreement.

Moreover, the court of appeals noted that even if the partnership had been at will and, therefore, dissolved when Clarkson left the partnership, Beck could still recover from Clarkson because Clarkson may have breached the fiduciary duty she owed to Beck as a partner.²⁴ The *Beck* court held that the U.P.A. "makes it clear that an act of dissolution does not terminate the partnership. It is equally clear that dissolution does not extinguish the partner's fiduciary duties owed one to the other."²⁵ The court held that Clarkson may have violated her fiduciary duty to Beck because she may have breached a duty not to compete

Id. (quoting 59A AM. JUR. 2D *Partnership* § 819 (1987) (emphasis added)).

20. *Id.*

21. S.C. CODE ANN. § 33-41-910 (Law. Co-op. 1990).

22. *Id.* § 33-41-930(1)(b).

23. *Id.*

24. *Beck*, 300 S.C. at 304, 387 S.E.2d at 687.

25. *Id.* at 303, 387 S.E.2d at 686. South Carolina Code section 33-41-540(1) states that "[e]very partner must account to the partnership for any benefit and hold as trustee for it any profits derived by him without the consent of the other partners from any transaction connected with the formation, conduct or liquidation of the partnership or from any use by him of its property." S.C. CODE ANN. § 33-41-540 (Law. Co-op. 1990). See also *Few v. Few*, 239 S.C. 321, 122 S.E.2d 829 (1961) (partners are treated as fiduciaries to each other; their relationship is one of mutual trust and confidence, imposing upon them the usual trust requirements of loyalty, good faith, and fair dealing).

with the partnership.²⁶ Clarkson's withdrawal also might have constituted a breach of contract by wrongful dissolution.²⁷ Thus, regardless of whether the partnership was at will, Clarkson could be liable to Beck for a breach of fiduciary duty.²⁸

Finally, the court turned its attention to whether Beck's claim for damages was too speculative to allow the case to go to a jury.²⁹ The trial court determined that Beck's claim for damages was too speculative because lost profits from a new business are per se nonrecoverable.³⁰ In *Drews Co. v. Ledwith-Wolfe Associates*³¹ the South Carolina Supreme Court held that South Carolina should "unequivocally join those jurisdictions applying the new business rule as a rule of evidentiary sufficiency and not as an automatic preclusion to recovery of lost profits by a new business or enterprise."³² The *Beck* court, therefore, followed recent South Carolina precedent and reversed the trial court on the question of evidentiary sufficiency.

In *Drews* the court set forth the following three requirements to determine lost profits: (1) the lost profits must be a natural consequence of the breach; (2) the lost profits must be foreseeable; and (3) the aggrieved party must establish the lost profits with reasonable certainty, not conjecture or speculation.³³ To determine what constitutes reasonable certainty, the South Carolina Supreme Court in *South Carolina Finance Corp. of Anderson v. West Side Finance Co.*³⁴ held that "[t]he law does not require absolute certainty of data upon which lost profits are to be estimated . . . and it is sufficient if there is a certain standard or fixed method by which profits sought to be recovered may be estimated and determined with a fair degree of accuracy."³⁵ The *Beck* court wrote that "[i]n the case of a partner wrongfully excluded from the business, resulting in a dissolution of the partnership as to him, his entitlement is to his share of the profits on the completion of the venture"³⁶ Beck, therefore, might be entitled to a substantial share of the profits even though he contributed nothing to the business after the first six months of the partnership. Although this may not

26. *Beck*, 300 S.C. at 304, 387 S.E.2d at 687.

27. *Id.*

28. *Id.*

29. *See id.* at 297-300, 387 S.E.2d at 683-86.

30. *Id.* at 297, 387 S.E.2d at 683 (citing *Standard Supply Co. v. Carter & Harris*, 81 S.C. 181, 62 S.E. 150 (1907)).

31. 296 S.C. 207, 371 S.E.2d 532 (1988).

32. *Id.* at 212, 371 S.E.2d at 535.

33. *Id.* at 213, 371 S.E.2d at 535-36.

34. 236 S.C. 109, 113 S.E.2d 329 (1960).

35. *Id.* at 122-23, 113 S.E.2d at 336 (citations omitted).

36. *Beck*, 300 S.C. at 299, 387 S.E.2d at 684 (quoting 59A AM. JUR. 2d *Partnership* § 566 (1987)).

seem equitable, the court is sending a message to the business community: do not breach your duty of loyalty to your partner.³⁷

The South Carolina Court of Appeals has broken new ground with its decision in *Beck*. It has made it very difficult for parties to enter into an at-will partnership even in the absence of an agreement. Thus, the lesson of *Beck* is that it is never too early in a business relationship to enter into a written agreement which will define the rights and duties of the parties. The written agreement helps parties to avoid disputes, establish proof of the relationship, and avoid litigation. The lack of a written agreement may give a court and a jury the opportunity to speculate later about the parties' intentions.

Matthew J. Norton

II. MAJORITY SHAREHOLDERS GENERALLY OWE NO DUTY TO MINORITY SHAREHOLDERS FOR A PREMIUM THEY RECEIVE ON SALE OF STOCK

In *Shoaf v. Warlick*³⁸ the South Carolina Court of Appeals held that majority shareholders generally do not owe a duty to minority shareholders to refuse, or to share, the premium paid for their controlling block of stock.³⁹

The case arose from the sale of the controlling shares of the Coca-Cola Bottling Company of Anderson (Coke-Anderson) to the Coca-Cola Bottling Company of Asheville (Coke-Asheville). Coke-Asheville approached Paul W. Warlick, Jr., Coke-Anderson's chief executive officer and controlling shareholder, with an offer to purchase his controlling shares. Mr. Warlick did not negotiate the \$4,000,000 offer for his shares. He did, however, negotiate the offer for the minority shares from an initial offer of \$11,000 per share to the actual price of \$14,000 per share. Coke-Asheville informed the minority shareholders of the proposed sale about a month before Mr. Warlick granted an option to Coke-Asheville for his shares. A few months later, the plaintiffs, Wayne H. Shoaf and Perry L. Jones, accepted an offer from Coke-Asheville of \$14,000 per share for their holdings. The plaintiffs alleged that Warlick breached a fiduciary duty and took an improper premium for his shares. The trial court found that Warlick breached no fiduciary duty and granted summary judgment in favor of the defendant.⁴⁰

South Carolina courts traditionally considered stock to be personal

37. See S.C. CODE ANN. §§ 33-41-530 to -540 (Law. Co-op. 1990) (partners' duty to disclose information and duty as a fiduciary).

38. 298 S.C. 415, 380 S.E.2d 865 (Ct. App. 1989).

39. *Id.* at 418-19, 380 S.E.2d at 866-67.

40. *Id.* at 416-18, 380 S.E.2d at 865-66.

property.⁴¹ The courts have been hesitant to dictate how shareholders may dispose of their property. The *Shoaf* court recognized that the South Carolina Supreme Court regards stock as personal property and repeatedly has adhered to this rule.⁴² The court held that a shareholder is not required to share part of the price he receives for his stock with other shareholders.⁴³

The *Shoaf* decision follows the majority rule on this question.⁴⁴ Apparently, no jurisdiction holds that majority shareholders have a duty to refuse a premium on the sale of their stock. Many early writers argued that premiums for sale of control were improper and the seller should not retain them.⁴⁵ Recently, however, writers have argued that premiums are acceptable and even beneficial.⁴⁶ Throughout the debate, courts have generally retained the rule that a majority shareholder may sell his shares at the highest price he can obtain and is not under a duty to share the premium he receives with minority shareholders.⁴⁷ This is true even when the shareholder is an officer or director.⁴⁸

Although the courts have not recognized a duty to refrain from taking a premium, some exceptions exist.⁴⁹ Minority shareholders can look to these exceptions for relief in certain circumstances, and majority shareholders should be cautious about them.

South Carolina controlling shareholders could be liable for a premium when the purchaser of the controlling shares loots the assets of the corporation after the sale. Looting occurs when the buyer of the

41. See, e.g., *McLeod v. Sandy Island Corp.*, 265 S.C. 1, 7, 216 S.E.2d 746, 748 (1975); *Alderman v. Alderman*, 178 S.C. 9, 43, 181 S.E. 897, 911 (1935).

42. 298 S.C. at 418, 380 S.E.2d at 866.

43. *Id.* (quoting *Swinney v. Keebler Co.*, 480 F.2d 573, 577 (4th Cir. 1973)). The *Shoaf* court stated that "stockholders must 'necessarily act for themselves, and not as trustees for other stockholders.'" *Id.*

44. See, e.g., *McDaniel v. Painter*, 418 F.2d 545 (10th Cir. 1969); *Ruby v. Dunnett*, 88 F.2d 68 (10th Cir. 1937), cert. denied, 301 U.S. 706 (1937); *Benton v. United States*, 114 F. Supp. 37 (M.D. Ga. 1953); *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969); *Bart v. Pine Grove, Inc.*, 326 Ill. App. 426, 62 N.E.2d 127 (1945); *Nelson v. Northland Life Ins. Co.*, 197 Minn. 151, 266 N.W. 857 (1936); *Levy v. American Beverage Corp.*, 265 A.D. 208, 38 N.Y.S.2d 517 (App. Div. 1942); *Tryon v. Smith*, 191 Or. 172, 229 P.2d 251 (1951); *Thompson v. Hambrick*, 508 S.W.2d 949 (Tex. Ct. App. 1974).

45. See, e.g., Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628, 629 (1965).

46. See, e.g., Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1977).

47. See O'Neal, *Symposium: Sale of Control-Introduction*, 4 J. CORP. L. 239, 239 (1979). "With only frequent and relatively minor exceptions, the courts still adhere to the traditional view that a shareholder . . . may sell his shares . . . for whatever price he can obtain, even if his shares constitute a controlling block and the price per share is enhanced by that fact." *Id.*

48. *Id.*

49. See *infra* notes 51, 56, 59, 62 and accompanying text.

controlling shares improperly converts the assets of the corporation for his personal use to the detriment of the minority shareholders or creditors.⁵⁰ South Carolina courts would probably adopt the Fourth Circuit's view that the seller of controlling shares may have a duty to investigate.

In *Swinney v. Keebler*⁵¹ the Fourth Circuit Court of Appeals held that if the circumstances of the offer would cause a prudent person to believe looting could occur, the controlling shareholder has an affirmative duty to conduct a reasonable investigation to determine whether looting is likely to occur.⁵² Factors which give rise to a duty to investigate include bad credit reports, unsatisfied judgments, an inflated price, and indications that the purchaser wants control of liquid assets as soon as possible.⁵³ When the buyer appears reputable and financial statements indicate an ability to purchase the corporation without resort to looting, the seller does not have a duty to investigate.⁵⁴ When the seller of control shares does not fulfill the duty to investigate and looting occurs, however, the seller is liable.⁵⁵

Another limitation on the general rule that would probably apply in South Carolina affects shareholders when the sale is really a sale of the corporate management. This arises when the purchase of the stock is secondary to securing a management position of officer or director.⁵⁶ Although this exception appears broad because the sale of a controlling block of stock usually passes the ability to assume a management position, its application is quite limited. Courts have recognized this limitation only when the percentage of shares purchased is very low, less than 10 percent, and a portion of the purchase price is specifically allocated to managerial control.⁵⁷ A sale of corporate management is improper because it is essentially the buying of corporate offices. A purchase of this type is improper, whether it is made directly or disguised by the purchase of a nominal amount of shares.⁵⁸

50. See Hayes, *Sale of Control of a Corporation: Who Gets the Premium*, 4 J. CORP. L. 243, 243 (1979).

51. 480 F.2d 573 (4th Cir. 1973).

52. *Id.* at 577-78.

53. See *id.*

54. *Id.* at 575.

55. See Hayes, *Sale of Control of a Corporation: Who Gets the Premium*, 4 J. CORP. L. 243, 251 (1979).

56. See *id.* at 248-50.

57. See, e.g., *Nelson v. Gammon*, 478 F. Supp. 630, 634-37 (W.D. Ky. 1979), *aff'd*, 647 F.2d 710 (6th Cir. 1981). See generally 12B W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5805.20, at 143 (rev. perm. ed. 1980) (this exception arises when it is possible to acquire managerial control by purchasing a small percentage of the stock).

58. See Hayes, *Sale of Control of a Corporation: Who Gets the Premium*, 4 J.

The South Carolina Supreme Court has not indicated whether it would recognize this limitation. The *Shoaf* court, however, noted with approval a decision of the Florida Court of Appeals which holds that parties cannot sever and sell the management control of a corporation separately from the voting stock representing this control.⁵⁹

South Carolina courts probably would follow the widely recognized limitation that a majority shareholder is liable for the premium he receives when he, in effect, sells a corporate asset that belongs to all shareholders. *Perlman v. Feldmann*⁶⁰ involved this type of sale. In *Perlman* a group of steel customers purchased a steel manufacturer for a premium in order to secure a source of steel in a tight market.⁶¹ Because the customers of the manufacturer now owned the manufacturer, the manufacturer could not charge higher prices on the open market. In these circumstances, the buyer is not paying a premium for a controlling interest in the corporation. Instead, he is purchasing an asset of the corporation: the output of the manufacturer at below-market prices. These assets belong to all shareholders. This type of sale results in lost profits to the corporation and, therefore, injures the minority shareholders. This situation is not a true exception to the general rule because the buyer is not really paying the premium for the controlling block of shares.

Some courts apparently recognize that the seller may have a fiduciary duty to the minority shareholders to make reasonable efforts on their behalf and to inform them of the transaction.⁶² These decisions, however, are infrequent, and usually occur when the seller abuses his advantage.⁶³ The court of appeals apparently rejected this type of common law duty in *Shoaf*. The court quoted from *Martin v. Marlin*:⁶⁴

CORP. L. 243, 249 (1979) (in its most blatant form, the surrender of executive or board of director positions is made part of the deal and is, in fact, what the deal is all about).

59. *Shoaf v. Warlick*, 298 S.C. 415, 418-19, 380 S.E.2d 865, 866-67 (Ct. App. 1989) (citing *Martin v. Marlin*, 529 So. 2d 1174 (Fla. Dist. Ct. App.), *reh'g denied*, 539 So. 2d 475 (Fla. 1988)). Part of the *Martin* opinion that is not quoted in *Shoaf* states that there are "well-established principles of equity that a corporate officer or director may not sell such office for personal gain [but that this rule] is limited to situations where the sale of the corporate office is 'by itself' (i.e., unaccompanied by sufficient stock to carry voting control)." *Id.* (emphasis added).

60. 219 F.2d 173 (2d Cir.), *cert. denied*, 349 U.S. 952 (1955).

61. *Id.* at 175.

62. *Brown v. Halbert*, 271 Cal. App. 2d 252, 76 Cal. Rptr. 781 (1969) (a majority shareholder-director case).

63. See, e.g., *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (majority shareholders created a market for their block of stock while excluding the other shareholders and, thus, rendered the majority shareholders' stock much less valuable).

64. 529 So. 2d 1174 (Fla. Dist. Ct. App.), *reh'g denied*, 539 So. 2d 475 (Fla. 1988).

[T]he courts generally hold that neither the selling shareholder nor his purchaser is under an obligation to see that other shareholders are provided opportunities to sell their shares on the same favorable terms as the controlling shareholder or even to inform minority shareholders of the sale of the controlling interest.⁶⁵

Although the *Shoaf* court seems to reject this exception, it could follow the lead of other courts and allow an action like fraud when the majority shareholder is particularly abusive.⁶⁶ The majority shareholder in *Shoaf* did not abuse his position. The court, therefore, wisely left open the option to use exceptions to deal with situations in which the majority shareholder is not so benign. The *Shoaf* decision not only follows case law, but also seems empirically and economically correct. A rule that makes receiving a premium for controlling shares improper would drastically change the long-established method of selling controlling blocks of stock. In addition, the controlling block of stock is a different commodity than other shares. It carries the right of control. It seems equitable to require and receive a higher price for the right to control the business. Finally, requiring buyers to pay a premium to all shareholders will either increase the cost to them or will lower the price paid to the majority shareholder. This result will decrease the number of controlling share sales and thereby discourage economic efficiencies that arise from placing assets in the hands of those who value them most and feel they can better maximize the economic benefit of the assets.

The *Shoaf* court expressly held that majority shareholders in South Carolina do not have a duty to refrain from taking a premium on their stock. Minority shareholders have no right to share this premium or even to be informed of the majority shareholder's offer.⁶⁷ The majority shareholder's right to receive a premium, however, probably does not allow him to, in effect, sell a corporate asset or office, nor to defraud the corporation or the minority shareholders. If the premium is truly given in exchange for the controlling shares, it seems appropriate.

The *Shoaf* court based this decision on a well-established rule. The decision also is consistent with the traditional rules governing stock sales in South Carolina.

Charles F. Thompson, Jr.

65. *Shoaf v. Warlick*, 298 S.C. 415, 419, 380 S.E.2d 865, 867 (Ct. App. 1989) (quoting *Martin*, 529 So. 2d at 1177).

66. Hamilton, *Private Sale of Control Transactions: Where We Stand Today*, 29 CORP. PRAC. COMMENTATOR 1, 33-34 (1987).

67. 298 S.C. at 420, 380 S.E.2d at 867.

III. FORMER SHAREHOLDER LACKS STANDING TO MAINTAIN DIRECT ACTION AGAINST PRESIDENT FOR BREACH OF DUTY OWED TO CORPORATION

In *Davis v. Hamm*⁶⁸ the South Carolina Court of Appeals held that a former shareholder cannot bring a direct action against a corporate director for misappropriation of corporate assets and breach of fiduciary duty.⁶⁹ The court, however, recognized that an officer or director's failure to make a full disclosure of all relevant facts, when purchasing shares of stock from a stockholder, will result in a viable cause of action for the shareholder against the officer or director.⁷⁰

In *Davis* the corporation, TICOA Investments, Inc. (TICOA), had five shareholders. The plaintiff, Davis, was a former shareholder. The defendant Hamm had been both the president and a director of the corporation. The corporation entered into a lease agreement for the lease of a computer. Hamm personally guaranteed the lease. The corporation missed several lease payments, however, and the bank demanded the return of the computer. Hamm removed the computer from the corporation's place of business, had it refinanced in his own name, and informed the corporation that he intended to hold the computer until the corporation relieved him of his personal obligation to the bank. Davis alleged the defendant breached his fiduciary duty, mismanaged the corporate assets, and that this action caused the value of TICOA stock to decrease. Davis sold his stock at a decreased value and later brought this action for damages.⁷¹

A general rule in corporate law provides:

A stockholder may individually sue corporate directors, officers, or other persons when he has sustained a loss separate and distinct from that of other stockholders generally. However, an individual has no right to bring an action in his own name and in his own behalf for a wrong committed solely against the corporation.⁷²

68. 300 S.C. 284, 387 S.E.2d 676 (Ct. App. 1989).

69. *Id.* at 288, 387 S.E.2d at 678.

70. *Id.* at 289, 387 S.E.2d at 679. In *Jacobson v. Yaschik*, 249 S.C. 577, 155 S.E.2d 601 (1967), one shareholder, the president of the corporation, entered into a contract to sell all of the capital stock in the corporation to a third party. At the same time the president bought the corporation's only other shareholder's stock at a lower price. The president failed to disclose the contract to sell all of the capital stock to a third party to the other shareholder before he bought the stock. The South Carolina Supreme Court held that the officer breached a fiduciary duty when he withheld relevant information when he bought the shareholder's stock, and the court allowed the former shareholder to maintain a cause of action against the officer. *Id.* at 585-86, 155 S.E.2d at 606.

71. *Davis*, 300 S.C. at 286, 387 S.E.2d at 677.

72. *Ward v. Griffin*, 295 S.C. 219, 221, 367 S.E.2d 703, 704 (Ct. App. 1988) (quoting 19 AM. JUR. 2D *Corporations* § 2245, at 147 (1986)). See *Strickland v. Flue-Cured To-*

Courts generally hold that a director's breach of a fiduciary duty to the corporation or mismanagement of corporate assets is a wrong to the corporation and gives rise to actions by or on behalf of the corporation.⁷³ These courts do not allow direct actions by individual stockholders because this would open the door for voluminous litigation, benefit one shareholder at the expense of others, and ignore the corporate entity.⁷⁴ In South Carolina, however, a director has the express duty to act "in a manner he reasonably believes to be in the best interests of the corporation and its shareholders."⁷⁵ Unlike the drafters of the Model Act,⁷⁶ however, the South Carolina Legislature specifically retained the language "and its shareholders." According to the South Carolina reporters' comments to section 33-8-300, shareholders are express statutory beneficiaries of fiduciary duties owed by corporate insiders.⁷⁷ The purpose of including shareholders in the South Carolina Act was "to make clear that the fiduciary duty of directors runs to the shareholders, and prevents directors from making use of their favored position to take advantage of shareholder interests."⁷⁸

Courts have allowed shareholders and former shareholders of close corporations to bring direct actions against directors for breach of fiduciary duty or mismanagement of corporate assets.⁷⁹ Courts allow a di-

bacco Coop. Stabilization Corp., 643 F. Supp. 310, 316 (D.S.C. 1986) (shareholder must bring derivative suit).

73. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 360, at 1049-50 (1983) (lists wrongs that give rise to derivative actions); 2 H. O'NEAL & R. THOMPSON, CLOSE CORPORATIONS § 8.11, at 119-26 (3d ed. 1988). *See also* *Ward*, 295 S.C. at 221, 367 S.E.2d at 704 (derivative action lies only when the injury is not separate and distinct).

74. *E.g.*, *Johnson v. Gilbert*, 127 Ariz. 410, 412, 621 P.2d 916, 918 (Ct. App. 1980); *see Kirk v. First Nat'l Bank of Columbus*, 439 F. Supp. 1141, 1149 (M.D. Ga. 1977) (when corporation can no longer recover, individual shareholder has standing to sue); *Funk v. Spalding*, 74 Ariz. 219, 225-26, 246 P.2d 184, 188 (1952).

75. S.C. CODE ANN. § 33-8-300(a)(3) (Law. Co-op. 1990).

76. REVISED MODEL BUSINESS CORP. ACT § 8.30 (1984).

77. S.C. CODE ANN. § 33-8-300 reporters' comments (Law. Co-op. 1990).

78. *Id.*

79. *See, e.g.*, *Watson v. Button*, 235 F.2d 235 (9th Cir. 1956) (former fifty percent shareholder allowed to bring a direct action against other fifty percent shareholder for fraud against the corporation, which caused decrease in value of stock); *Kirk v. First Nat'l Bank of Columbus*, 439 F. Supp. 1141 (M.D. Ga. 1977) (former shareholder of close corporation allowed to bring direct action against director for breach of fiduciary duty, which resulted in decrease in value of stock despite possibility of multiplicity of suits by other former shareholders); *Donahue v. Rodd Electrotpe Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975) (minority shareholder allowed a direct action against majority shareholder because of heightened fiduciary duty and the fundamental resemblance of a close corporation to a partnership); *Miller v. Ruth's of N.C., Inc.*, 68 N.C. App. 40, 313 S.E.2d 849 (1984) (individual action held more appropriate than derivative action when twenty percent shareholder sued eighty percent shareholder); *Crosby v. Beam*, 47 Ohio St. 3d 105, 548 N.E.2d 217 (1989) (former shareholder allowed to bring a direct action for breach of

rect action in close corporations because corporate recovery in a derivative suit remains under the control of the same parties who were the defendants in the litigation.⁸⁰ Moreover, if the minority shareholders sue the majority shareholder directors for a breach of fiduciary duty and the corporation recovers from them, the recovery itself is a corporate asset under the control of the majority shareholder. The minority shareholders, therefore, who brought the action may receive no benefit. Courts also have recognized that a close corporation resembles a partnership and, therefore, courts apply partnership law in some situations.⁸¹

In *Davis* the lower court divided the case into the following two issues: (1) whether a shareholder could bring a direct action against a director for breach of fiduciary duty, and (2) whether a former shareholder could bring such an action. The court of appeals, however, stated that no liability to shareholders for breach of fiduciary duty exists unless the breach of fiduciary duty is a failure to make a full disclosure of relevant facts or is an action brought by minority shareholders of a close corporation pursuant to sections 33-14-300 to -330 of the South Carolina Code.⁸² This holding is a distinct departure from the statutory duty that the law imposes on directors to act on behalf of the shareholders.⁸³ The court of appeals also stated that "[t]he case before us, however, does not constitute a proper vehicle to apply the principles of law involved in this burgeoning field of litigation between shareholders in very close corporations."⁸⁴ The court's analysis seems flawed, however, because the corporation in *Davis* was a close corporation.⁸⁵ Although the plaintiff sold his stock and was no longer a shareholder, the litigation arose out of conflicts between shareholders in a

fiduciary duty which caused devaluation of stock).

80. 2 H. O'NEAL & R. THOMPSON, *supra* note 73, § 8.11, at 122 (3d ed. 1988).

81. See, e.g., *Johnson v. Gilbert*, 127 Ariz. 410, 412, 621 P.2d 916, 918 (Ct. App. 1980); *Donahue*, 367 Mass. at 586-87, 328 N.E.2d at 515.

82. *Davis*, 300 S.C. at 292, 387 S.E.2d at 680. Section 33-14-300 of the South Carolina Code allows the shareholder to bring a proceeding only for corporate dissolution and not for damages. S.C. CODE ANN. § 33-14-300 (Law. Co-op. 1990). The holding, therefore, does not allow a shareholder in a close corporation to bring a direct suit for damages. Later in the opinion, however, the court implies that minority shareholders in close corporations have other remedies. *Davis*, 300 S.C. at 291, 387 S.E.2d at 680.

83. See S.C. CODE ANN. § 33-8-300 (Law. Co-op. 1990).

84. *Davis*, 300 S.C. at 288-89, 387 S.E.2d at 678.

85. Commentators generally have defined close corporations as corporations with the following elements: (1) only a few shareholders, (2) shares not generally traded in the securities market, and (3) all stock held by persons who are active in the management and conduct of the business. See, e.g., 2 H. O'NEAL & R. THOMPSON, *supra* note 73, § 1.02, at 2-9. The corporation in *Davis* had only five shareholders, no generally traded stock, and most shareholders were also officers and directors of the corporation.

close corporation, and, therefore, the principles of close corporations should have been applied.

In *Davis* several factors indicate that a denial of a direct action is appropriate. The loss was a loss to the corporation and not a loss to an individual shareholder separate from that of shareholders generally. Furthermore, the defendant was not the majority shareholder⁸⁶ and was no longer in control of the corporate functions.⁸⁷ Accordingly, the defendant could not have controlled the corporate recovery in a derivative suit to the detriment of the other shareholders. Finally, a direct action might subject the defendant to a multiplicity of suits and interfere with the fair distribution of the recovery.⁸⁸

In *Crosby v. Beam*⁸⁹ the Ohio Supreme Court held that a former shareholder could bring a direct action for damages for breach of fiduciary duty against the controlling shareholders. The plaintiff alleged that the three controlling shareholders, who were also directors and officers, misappropriated corporate funds by paying themselves unreasonable salaries, paying their personal expenses, and using corporate property for personal enterprises. The court recognized the distinctions associated with close corporations and the disadvantages of derivative suits.⁹⁰ The court emphasized the oppression by the majority shareholders by creating a disadvantageous situation for the minority shareholder.⁹¹ A comparison of *Davis* and *Crosby* reveals the following distinctions: (1) the alleged breach in *Crosby* was an oppressive use of the controlling power, while in *Davis* no oppressive conduct existed; (2) in *Davis* the plaintiff was not the only injured party; and (3) in *Crosby* the defendant would be in control of any recovery in a derivative suit. Moreover, the facts in *Crosby* were associated more closely with the reasons to grant a direct action than the facts in *Davis*.

If the Ohio Supreme Court heard a case factually similar to *Davis*,

86. The record does not indicate the exact percentage of shares held by the defendant, but it appears that it was less than a majority.

87. The defendant was no longer the managing officer or director. Brief of Appellant at 2.

88. If the plaintiff was successful in his direct action, the other shareholders certainly would bring similar actions and argue that they were injured similarly. If the defendant had become judgment proof after the first action, then the recovery would have been unfairly distributed to the first plaintiff. The court could solve this problem by making the plaintiff's recovery contingent upon the fair distribution to other similarly-situated plaintiffs.

89. 47 Ohio St. 3d 105, 548 N.E.2d 217 (1989).

90. *Id.* at 109-10, 548 N.E.2d at 221.

91. The Ohio Supreme Court specifically held that "claims of a breach of fiduciary duty alleged by minority shareholders against shareholders who control a majority of shares in a close corporation, and use their control to deprive minority shareholders of the benefits of their investment, may be brought as individual or direct actions." *Id.*

it might not allow a direct action because of the limited language of the holding, which seems to require oppressive conduct by majority shareholders and not just a breach of fiduciary duty by a director.⁹² The more important question is whether a South Carolina court would allow a direct action in a case factually similar to *Crosby*.

The first question is whether *Davis* restricts a shareholder from bringing a direct action against the director. The holding in *Davis* indicates that a director only owes a duty to the corporation for appropriation of corporate assets and that a breach of this duty does not extend to the individual shareholder. This holding, therefore, is a distinct departure from the interpretation of the statute by the South Carolina reporter.⁹³ In *Davis* the court of appeals stated that liability to shareholders is not present for a breach of fiduciary duty unless the officer withheld information⁹⁴ or the minority shareholders of a close corporation brought the action pursuant to sections 33-14-300 to -330.⁹⁵ This statement appears to be overly restrictive and should not be misread. Section 33-14-300(2)(ii) allows a shareholder to bring an action to dissolve the corporation if "the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, fraudulent, oppressive, or unfairly prejudicial"⁹⁶ Nevertheless, sections 33-14-300 to -330 do not authorize a shareholder to bring a direct action for damages. The shareholder arguably could recover his share of the corporate assets upon dissolution or force a fair buy-out settlement in this type of proceeding,⁹⁷ but dissolution may not be preferred. It appears, however, that the court leaves the door open for future cases in which shareholders may emphasize the oppression of minority shareholders by the majority.⁹⁸

The second question is whether *Davis* absolutely bars a former shareholder from bringing a direct action. The court did not overrule the exception of *Jacobson v. Yaschik*⁹⁹ in which a director failed to

92. See *id.*

93. See S.C. CODE ANN. § 33-8-300, reporters' comments (Law. Co-op. 1990).

94. *Davis v. Hamm*, 300 S.C. 284, 289, 387 S.E.2d 676, 679 (Ct. App. 1989).

95. See *supra* note 82 and accompanying text.

96. S.C. CODE ANN. § 33-14-300(2)(ii) (Law. Co-op. 1990).

97. See Haynsworth, *The Effectiveness of Involuntary Dissolution Suits As a Remedy For Close Corporation Dissension*, 35 CLEV. ST. L. REV. 25 (1986-87) (discussion of available shareholder remedies).

98. The court in *Davis* stated, "The South Carolina statutes provide a wide range of relief for minority stockholders" 300 S.C. at 786, 387 S.E.2d at 680.

99. 249 S.C. 577, 155 S.E.2d 601 (1967). This exception might be sufficiently broad to encompass any claim in which the purchaser did not give the former shareholder full disclosure of the facts before he sold his stock. The court's acceptance of the facts of *Watson* within the exception of *Jacobson* indicates the court will broadly read the exception.

disclose relevant facts to former shareholders. Absent a *Jacobson* claim, however, the holding in *Davis* indicates that once a shareholder sells his stock, the shareholder has no further remedy for a director's breach of fiduciary duty.¹⁰⁰

Because of *Davis* a close corporation minority shareholder may be trapped. The shareholder may have only the following four true alternatives: (1) sell the stock to mitigate damages,¹⁰¹ (2) keep the stock and bring a derivative suit,¹⁰² (3) keep the stock and bring a dissolution proceeding,¹⁰³ or (4) keep the stock and bring a direct action for damages.¹⁰⁴ If the shareholder sells the stock, then this sale, under *Davis*, precludes the shareholder from bringing a direct action. If the shareholder keeps the stock, the shareholder risks further devaluation due to other misappropriations by the majority shareholder or directors. Mitigation of damages is an established concept in most areas of the law, and it is inequitable to penalize the minority shareholder for trying to minimize his losses, especially upon consideration of the questionable, if not fraudulent, actions of the benefited party.

The legal rule that no duty extends to the shareholder for misappropriation of corporate assets makes it clear that only a corporation can maintain an action. The rule, however, may result in inequitable remedies for shareholders, especially in close corporations. The corporation has a right to sue a director for misappropriation of assets, but a former shareholder who is forced to sell his stock by the same breach also should have this right. The court should be able to use its equitable powers, such as joinder and interpleader, to allow an equitable recovery and distribution of the recovery. The Supreme Court of Ohio seems to have adopted the more equitable rule which allows the former shareholder to bring a direct action, and South Carolina courts argua-

100. In *Davis* the court partially distinguished *Watson* because no danger of multiplicity of suits or prejudice to another shareholders' interest existed.

101. The minority shareholder normally will have to sell his shares to another shareholder because no other market for his stock exists. In such a case he probably will not receive the fair market value for the stock. See *Donahue v. Rodd Electrotape Co.*, 367 Mass. 578, 590-91, 328 N.E.2d 505, 514 (1975).

102. If the derivative suit is successful, the majority shareholders, against whom the minority shareholders brought suit, will still be in control of the recovery because it is part of the corporate assets. See generally 2 H. O'NEAL & R. THOMPSON, *supra* note 73, § 8.11, at 122.

103. This remedy might not be advantageous because the dissolution value might be significantly lower than the true value of the corporation. The value of the corporation at dissolution would also be significantly less after the directors have siphoned the profits over a period of time. Therefore, a damages action also might be necessary for a true remedy.

104. As previously discussed, this may not be an available remedy after the specific holding in *Davis*.

bly should adopt a similar rule given the specific language of the South Carolina statute that deals with directors' duties.

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